

FILE COPY



SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 419

R. SIMPSON & CO., INC.,

*Petitioner,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE SECOND CIRCUIT AND BRIEF IN SUP-  
PORT THEREOF.

GERALD DONOVAN,  
*Counsel for Petitioner.*

*Of Counsel:*

JAMES T. HEENEHAN,

FRANCIS F. STEVENS.

## TABLE OF CONTENTS

	Page
Petition for writ of certiorari . . . . .	1
A. Summary statement of the matter involved . . . . .	1
B. Reasons relied on for the allowance of the writ . . . . .	3
C. Prayer for writ . . . . .	5
Brief in support of petition for certiorari . . . . .	6
I. Opinions of the courts below . . . . .	6
II. Jurisdiction . . . . .	6
III. Statement of the case . . . . .	7
IV. Specification of errors . . . . .	8
V. Argument . . . . .	8
Point I—Reasonably construed the statute has no application to corporations like the Petitioner . . . . .	8
Point II—As to the Petitioner's liability for penalties . . . . .	16
Point III—Sec. 351 of the Revenue Act, as construed by the Commissioner violates the Fifth Amendment to the Constitution of the United States . . . . .	18
Conclusion . . . . .	20
Appendix . . . . .	22

### TABLE OF CASES CITED.

<i>Automatic Fire Alarm Co. v. Bowers</i> , 51 F. (2d) 418 . . . . .	10
<i>Eaton v. Phoenix Securities Co.</i> , 22 F. (2d) 497, 498 . . . . .	10
<i>Flint v. Stone Tracy Co.</i> , 220 U. S. 107, 151 . . . . .	9
<i>Frost v. Corporation Commission</i> , 278 U. S. 515, 522 . . . . .	20
<i>Gould v. Gould</i> , 245 U. S. 151, 153 . . . . .	8
<i>Gulf, etc. R. Co. v. Ellis</i> , 165 U. S. 150, 155 . . . . .	20
<i>Heiner v. Donnan</i> , 285 U. S. 312, 328 . . . . .	18
<i>Heydenfeldt v. Daney Gold, etc. Co.</i> , 93 U. S. 634, 648 . . . . .	15
<i>Hooper v. Tax Commission</i> , 284 U. S. 206, 217 . . . . .	18
<i>Holy Trinity Church v. U. S.</i> , 143 U. S. 457, 459 . . . . .	15
<i>Lane Timber Co. v. Hynson</i> , 4 F. (2d) 666, 667 . . . . .	10
<i>Louisville Gas Co. v. Coleman</i> , 277 U. S. 32, 37 . . . . .	20
<i>Magruder v. W. B. &amp; A. Realty Corporation</i> , 120 F. (2d) 441, 444 . . . . .	10
<i>McCoach v. Minehill etc. Co.</i> , 228 U. S. 295, 303 . . . . .	9

	Page
<i>Nichols v. Coolidge</i> , 274 U. S. 531, 542	18
<i>O'Sullivan Rubber Co. v. Commissioner</i> , 120 F. (2d) 845, 849	17
<i>Reinecke v. Northern Trust Co.</i> , 278 U. S. 339, 348	9
<i>Royster Guano Co. v. Virginia</i> , 253 U. S. 412, 415	20
<i>Schlesinger v. Wisconsin</i> , 270 U. S. 230, 240	18
<i>Smietanka v. First Trust and Savings Bank</i> , 257 U. S. 602, 606	9
<i>U. S. v. Emery, Bird, Thayer Realty Co.</i> , 237 U. S. 28, 35	9
<i>U. S. v. Hotchkiss Redwood Co.</i> , 25 F. (2d) 958, 959	10
<i>U. S. v. Kirby</i> , 7 Wall. 482, 486, 487	14
<i>White v. Aronson</i> , 302 U. S. 16, 20	9
<i>Zonne v. Minneapolis Syndicate</i> , 220 U. S. 187, 190	9, 10

## STATUTES CITED.

Revenue Act of 1934, Sec. 291	24
Revenue Act of 1934, Sec. 351	6, 22
Revenue Act of 1936, Sec. 351	6
Revised Statutes, Sec. 3176, as amended	24

## OTHER AUTHORITIES CITED.

Encyclopedia of the Social Sciences, Vol. 8, page 131	15
Internal Revenue Bulletin for February 27, 1939, No. 9, page 23	12
Report of the Ways and Means Committee of the House, on the Revenue Bill of 1934	11

**SUPREME COURT OF THE UNITED STATES**

**OCTOBER TERM, 1942**

---

**No. 419**

---

**R. SIMPSON & CO., INC.,**

*Petitioner,*

*vs.*

**COMMISSIONER OF INTERNAL REVENUE.**

---

**PETITION FOR WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE SECOND CIRCUIT.**

---

**MAY IT PLEASE THE COURT:**

The petitioner, R. Simpson & Co., Inc., by its attorney, Gerald Donovan, respectfully shows to this Honorable Court:

**A.**

**Summary Statement of the Matter Involved:**

The principal questions presented are whether, during the taxable years in question (1934, 1935 and 1936), the petitioner, a corporation found by the Board of Tax Appeals to have been "actively engaged in the conduct of busi-

ness with the general public in the operation of its pawn shops" (R. 27) and not found by the Board to have held the securities of, or otherwise to have controlled, any other corporation, person or organization, was a personal holding company within the meaning of Section 351 of the Revenue Acts of 1934 and 1936, respectively, or either of said acts; whether the application to petitioner of said statutes, or either of them, is constitutional under the organic laws of the United States of America; and whether said statutes, or either of them, as applied to petitioner, are constitutional under the organic laws of the United States of America.

Subsidiary questions presented are whether the filing by petitioner of "its complete income and excess-profits tax returns, Form 1120, for the taxable years" (R. 27), the filing by petitioner of "information returns, Form 1096, with the attached Form 1099 listing the amounts of dividends over \$300 paid to its stockholders, for the years in question" (R. 27), and the further fact that "petitioner's books and records, which gave some indication that more than 50 per cent of its stock was owned by less than five stockholders and disclosed that at least 80 per cent of its income was derived from interest, were at all times available to respondent and were actually made available to respondent's agents during audit of the income tax returns for the taxable years" (R. 27, 28), constituted in substance and effect the filing of Form 1120-H (personal holding company return) or the equivalent thereof, or, at the very least, relieved petitioner from the imposition of penalties for failure to file said Form 1120-H.

## B.

**Reasons Relied on for the Issuance of the Writ.**

## I.

The facts clearly show that the taxpayer corporation is and always has been an active operating corporation engaged in a general pawnbroking and loan business upon pledges of personal property, duly licensed to conduct such active operating business by the Bureau of Licenses of New York City. It is not and never was an "incorporated pocketbook", which the personal holding company surtax was intended to penalize. The attempted application, by the respondent, of these personal holding company tax statutes to the petitioner is an attempt to create, by definition, a status contrary to fact and common sense—an attempt to declare that an active operating corporation is a holding company. And this in the face of holdings by this honorable court that a statute which seeks to create a status and denies a fair opportunity to rebut such classification violates the due process clause of the Fifth Amendment.

It has been said by high authority that the construction of tax statutes is a practical matter. But no one can reasonably assert that the classification and penalization of an innocent operating corporation as an undesired personal holding company, or "incorporated pocketbook" is a requisite to the proper, or even practical, collection of revenue. The attempted classification of the taxpayer as a personal holding company is, therefore, "unnecessary", "inappropriate", "unreasonably harsh" and "oppressive", when viewed in the light of any benefit to be expected by the Government. For the further reason that penalizing this class of taxpayer would not promote the legislative objective, the statutes in question, or such application by

the respondent, would violate the due process clause if imposed upon this active operating corporation.

The question here presented involves an important question of law, which, it is submitted, is controlled by principles of Federal tax law already laid down by this high Court, but not as yet dealt with by it in any case relating to personal holding company surtaxes. It is necessary for the public interest, particularly in this period of rapidly increasing taxation, that unconstitutional departure, by the Bureau of Internal Revenue, from said applicable principles, be corrected at the earliest possible moment so that the docket of this honorable Court be not flooded by applications for review of such illegal determinations. And more particularly the public interest would be served through the consideration by this Court of the question whether penalties against taxpayers are appropriated where there has been a bona fide and timely effort to make full and complete disclosure of all pertinent facts even though not in a technically formal manner.

## II.

The taxpayer filed, as found by the Board, "complete income and excess-profits tax returns, Form 1120, for the taxable years" (R. 27) and also, the Board found, filed "information, returns, Form 1096, with the attached form 1099 listing the amounts of dividends over \$300 paid to its stockholders, for the years in question" (R. 27). The Board found the further fact that "Petitioner's books and records, which gave some indication that more than 50 per cent of its stock was owned by less than five stockholders and disclosed that at least 80 per cent of its income was derived from interest, were at all times available to respondent and were actually made available to respondent's agents during audit of the income tax returns for

the taxable years" (R. 27, 28). It is, therefore, contended that the taxpayer submitted to respondent the equivalent of Form 1120-H (personal holding company return) at least to the extent necessary to avoid the imposition of penalties for failure to file said Form 1120-H.

WHEREFORE, petitioner respectfully prays that a Writ of Certiorari be issued out of and under the seal of this Honorable Court directed to the United States Circuit Court of Appeals for the Second Circuit, directing that court to certify and send to this Court, for its review and determination, on a day certain therein to be named, a full and complete transcript of the record and all proceedings in this case numbered and entitled on its docket "No. 147, *R. Simpson & Co. v. Commissioner of Internal Revenue*", and that said judgment of the United States Circuit Court of Appeals for the Second Circuit may be reversed by this Honorable Court, and that this petitioner may have such other and further relief in the premises as to this Honorable Court may seem meet and just.

September 2nd, 1942.

(Sgd.) GERALD DONOVAN,  
*Counsel for Petitioner.*

*Of Counsel:*

JAMES T. HEENEHAN,  
FRANCIS F. STEVENS.

## **BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.**

### **I.**

#### **The Opinions of the Courts Below.**

The opinion of the United States Circuit Court of Appeals for the Second Circuit, October Term, 1941, Docket No. 147, was rendered on June 19, 1942. It is to be found on page 49 of the record herein; the case is reported in 128 Fed. (2d) (Adv.) 742.

The opinion of the United States Board of Tax Appeals, B. T. A. Docket No. 98208, was rendered on May 14, 1941. It is to be found on pages 28-30 of the record herein; the case is reported in 44 B. T. A. 498, No. 80.

### **II.**

#### **Jurisdiction.**

1. The statutory provision believed to sustain jurisdiction is Section 240 of the Judicial Code as Amended by the Act of February 13, 1925 (C. 229 sec. 1, 43 Stat. 938).

2. The judgment sought to be reviewed was entered on July 6, 1942 (R. 50).

3. The proceeding in which review is sought was initiated in the United States Board of Tax Appeals. It involved the asserted liability of the petitioner for personal holding company taxes under Section 351 of the Revenue Acts of 1934 and 1936, respectively and the asserted liability of the petitioner for penalties for failure to file Form 1120-H (personal holding company return).

## III.

**Statement of the Case.**

The facts are not in dispute. R. Simpson & Co., Inc., the petitioner herein, "was incorporated under the laws of New York on July 1, 1918. It was qualified to conduct a general pawnbroking and loan business upon pledge of personal property, and was licensed to conduct such business by the Bureau of Licenses of New York City. Petitioner continued in corporate form a business that was established in 1824 (R. 26).

The business of the petitioner was conducted on a rather large scale. (See summary of petitioner's activities, for the taxable years involved, at page 26 of the Record.)

The petitioner maintains that it was and is entirely a business corporation in active operation. It has never conducted any business other than that of a pawnbroker. Nevertheless the respondent asserted deficiencies for alleged personal holding company surtax liability and, in addition, 25 per cent penalties for failure to file personal holding company returns. These amounts were summarized by the Board of Tax Appeals (R. 25) in the following manner:

Year	Deficiency	Penalty
1934	\$19,563.02	\$4,890.76
1935	29,355.07	7,338.77
1936	2,731.97	682.99

The full amount of the aforesaid asserted deficiencies and penalties is appealed herein.

## IV.

**Specification of Errors.**

The United States Circuit Court of Appeals for the Second Circuit erred in the following respects:

1. In holding that petitioner, an active operating corporation, was subject to tax as a personal holding company. It is contended that respondent's attempt to collect such taxes from the petitioner is unconstitutional because in violation of the due process clause of the Fifth Article of Amendment to the Constitution.

2. In holding that petitioner, an active operating corporation, was subject to penalties for failure to file personal holding company returns. In addition to the contention of unconstitutionality, it is further contended that petitioner's disclosures to respondent constituted the equivalent of filing such returns.

3. In holding that Section 351 aforesaid entitled "Sur-tax on Personal Holding Companies" was intended by Congress to apply to corporations which in truth and in fact were not personal holding companies in any sense of the term.

**V. Argument**

## POINT I.

**Reasonably construed the statute has no application to corporations like the Petitioner.**

In support of this statement, the Petitioner is entitled to rely upon an old and well established rule of law, viz., that, if there is reasonable doubt of the legislative intention to impose the tax, then that doubt must be resolved in favor of the taxpayer.

*Gould v. Gould*, 245 U. S. 151, 153;

*Smietanka v. First Trust and Savings Bank*, 257 U. S. 602, 606;

*Reinecke v. Northern Trust Co.*, 278 U. S. 339, 348;

*White v. Aronson*, 302 U. S. 16, 20.

(1)

*Prima facie the Petitioner's case is not one of those coming within the purview of the statute.*

It is undisputed that the Petitioner is an *operating* company, engaged in good faith in the transaction of a legal business. Such a corporation does not come within the description of the tax contained in the heading of Section 351, namely, a "SURTax ON PERSONAL HOLDING COMPANIES." A "holding company" is not an operating company. On the contrary, it is sharply differentiated from an operating company.

The term "holding company" is a familiar one. It is used to designate a corporation which has withdrawn from active business (if ever engaged in it), and whose activities are confined to holding the title to corporate stock or other property for convenience in manipulation. An excellent illustration is afforded by the Capital Stock Tax. That is a tax imposed upon the privilege of doing business in a corporate capacity (*Flint v. Stone Tracy Co.*, 220 U. S. 107, 151). Where the corporation has been engaged in the transaction of business the tax has always been imposed. On the other hand, where the corporation was not engaged in business, but was being used merely in order to hold the title to property, it has been held not to be subject to the tax. There are many such cases in the books.

*Zonne v. Minneapolis Syndicate*, 220 U. S. 187, 190;

*McCoach v. Minehill, etc., Co.*, 228 U. S. 295, 303;

*U. S. v. Emery, Bird, Thayer Realty Co.*, 237 U. S. 28, 35;

*Magruder v. W. B. & A. Realty Corporation*, 120 F. (2d) 441, 444;

*Lane Timber Co. v. Hynson*, 4 F. (2d) 666, 667;

*Eaton v. Phoenix Securities Co.*, 22 F. (2d) 497, 498;

*U. S. v. Hotchkiss Redwood Co.*, 25 F. (2d) 958, 959.

The inactive corporations in the cases cited were undoubtedly "holding companies" and they are sometimes so described.

"It (the corporation) is a holding company. It was organized as such in 1920 for the purpose of taking over and managing securities held by an operating company."

*Automatic Fire Alarm Co. v. Bowers*, 51 F. (2d) 118. (Emphasis added.)

A typical case is *Zonne v. Minneapolis Syndicate*, (220 U. S. 187). The decision is correctly syllabized as follows:

"A corporation the sole purpose whereof is to hold title to a single parcel of real estate subject to a long lease and, for convenience of the stockholders, to receive and distribute the rentals arising from such lease and proceeds of distribution of the land, and which has disqualified itself from doing any other business, is not a corporation doing business within the meaning of the corporation tax provision . . . and is not subject to the tax."

These cases are authority for the proposition that a "holding company" is never, *per se*, an operating company, since if it were an operating company it would be subject to capital stock tax, whereas the well settled law is that they are exempt from it. It may be that the same corporation, in addition to the active transaction of business, might also perform the functions of a "holding company," and that such a corporation would be subject to a tax on "holding companies" none the less that it also engaged in

ordinary business. It is enough to say that no such case is presented here. In addition to its business of pawn-broking the Petitioner had no business activities whatever.

(2)

*The definition of the "personal holding company" given in Section 351 of the statute is in complete accord with the headline of the Section.*

So far the argument has been based solely upon the description of the tax found in the headnote to Sec. 351. We pass now to the more detailed definition contained in a later part of the Section.

The interpretation that reconciles the headnote and body of Sec. 351 of the statute is that a corporation is not a "holding company" for the purposes of this surtax unless "at least 80 per centum of its gross income is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities," etc.

The purpose of this enactment is in no doubt whatever. It is stated with the utmost clearness in the Report of the Ways and Means Committee of the House on the Revenue Bill of 1934:

"Perhaps the most prevalent form of tax avoidance practiced by individuals with large incomes is the scheme of the 'incorporated pocketbook.' That is, an individual forms a corporation and exchanges for its stock his personal holdings in stock, bonds or other income-producing property. By this means the income from the property pays corporation tax, but no surtax is paid by the individual if the income is not distributed.

"For instance, suppose a man has \$1,000,000. annual income from taxable bonds. His tax under existing law will be \$571,100. However, if he forms a holding company to take title to the bonds and to receive

the income therefrom, the only tax paid will be a corporate tax of \$137,500. as long as there is no distribution of dividends. Thus a tax saving of \$433,600. has been effected." (Internal Revenue Bulletin for Feb. 27, 1939, No. 9, p. 23).

Here is a statement of the scope and purpose of the statute which must be accepted, both because it carries complete conviction, and because it comes from an official source. It establishes that the purpose of the enactment was to remedy an obvious case of tax avoidance. There is no pretense of such a thing in the case at bar. The Petitioner is an ordinary business corporation, transacting in good faith the business for which it was organized.

Congress—long hostile to false labelling—called this section a "SURTAX ON PERSONAL HOLDING COMPANIES." The Commissioner would have the body of the section apply to *operating* companies in some cases. It is not necessary to have such mislabelling. All antagonism and inconsistency are avoided if we accept the obvious explanation that Congress desired to surtax personal holding companies but was willing to allow even personal holding companies to escape if less than 80% of their income was of a holding company character. There was no intention of taxing strictly operating companies in any case.

That Congress meant what the heading said—"SURTAX ON PERSONAL HOLDING COMPANIES"—is further evidenced by the fact that the "gross income", the character of which may render a corporation liable to surtax is (with one exception) income accruing from the mere owning and holding of the stockholders' property as contrasted with the employment of corporate assets in an active business enterprise. That is true in the case of "royalties", "dividends", "interest" and "annuities". The case of "gains from the sale of stock or securities" presents somewhat different features but in no way affects the

general policy of the statute. That policy is clearly set forth in the report of the Ways and Means Committee already cited above (Page 10). It is to prevent the owner of income-producing property from avoiding a tax on that income.

(3)

*"Interest": as used in the body of Section 351 does not include such income as a pawnbroker's earnings.*

The "incorporated pocketbook" has always been a logical resting place for stocks and bonds. When Congress, seeking to curb the excessive use of this tax-avoiding device, employed the word "interest" in Section 351, it is natural to suppose that it meant the kind of interest incorporated pocketbooks would naturally be receiving. Ordinarily the incorporated pocketbook holds a debtor's promise to pay both principal and interest. This type of income—viz., the compensation paid by one man for the use of another man's money—was the income which Congress obviously wished to subject, in certain special cases, to surtax.

To make this "SURTAX ON PERSONAL HOLDING COMPANIES" apply to a pawnbroker, it is necessary to do two things:

(1) Assume that Congress when it said "interest" meant something much broader than the compensation one derives from the mere holding of the borrower's promise to pay;

(2) Assume that "interest" covers a pawnbroker's revenues *and the whole thereof*.

The assumption that a pawnbroker's so-called interest is the same sort of return Congress had in mind when it used "interest" is difficult in the light of the practical fact that a pawnbroker does not and never did hold the pledgor's promise to pay either interest or principal. If,

the pledgor for any reason or no reason decides not to pay either principal or so-called interest, he may not be sued. The pawnbroker's only remedy is to sell the pledged article pursuant to the provisions of the local governing statute. Construing the word "interest" very broadly, it might be applied to a pawnbroking transaction because, although the transaction is more akin to sale with the privilege of repurchasing at a higher price, the term interest has been used for centuries in respect of the excess paid by the pledgor over and above his "loan". If, however, so broad a construction would cause a conspicuously active operating corporation to be subjected to a "SURTAX ON PERSONAL HOLDING COMPANIES" it should not be adopted.

Even if a given construction of the language is within the strict letter of the statute, it will still not be adopted, where to do so would lead to absurd or unjust results or conflict with the obvious policy of the statute.

"All laws should receive a sensible construction. General terms should be so limited in their application as not to lead to injustice, oppression, or an absurd consequence. It will always, therefore, be presumed that the Legislature intended exception to its language, which would avoid results of this character. The reason of the law in such cases should prevail over its letter." (*U. S. v. Kirby*, 7 Wall. 482, 486, 487.)

"It is better always to adhere to a plain common sense interpretation of the words of a statute than to apply to them refined and technical rules of grammatical construction. . . . If a literal interpretation of any part of it would operate unjustly, or be contrary to the evident meaning of the act taken as a whole, it should be rejected. There is no better way of discovering its true meaning, when expressions in it are rendered ambiguous by their connection with other clauses than by considering the

necessity for it, and the causes which induced its enactment." (*Heydenfeldt v. Daney Gold, etc. Co.*, 93 U. S. 634, 648.)

"It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers. This has been often asserted, and the reports are full of cases illustrating its application." (*Holy Trinity Church v. U. S.*, 143 U. S. 457, 459.)

It cannot be said, however, in the case at bar that the language of the statute is such as to exclude absolutely any interpretation other than that for which the Respondent contends. The word in dispute is "interest." It has been defined as follows:

"Interest in its primary meaning is the payment for the use of money; more broadly, it may mean the return on investment in any form. In theoretical analysis it is generally taken to mean a 'pure' remuneration for the use of money, or yield on money capital; pure interest is deduced from nominal interest by elimination of all elements imputable to cost or effort of administration, to insecurity of payment of interest of principal, to prospective changes in the purchasing power of money and to amortization necessary to maintain the principal intact." (*Encyclopedia of the Social Sciences*, Vol. 8, p. 131.)

Certainly it is legitimate to give the word its "primary meaning" of a payment made *solely* for the use of money. Such a meaning precisely fits the case at bar. The uncontradicted testimony showed that R. Simpson & Co., Inc., averaged from 15% to 17% per annum on its pledges but that nearly a third of this was necessitated by special operating expenses peculiar to the pawnbroking business such as appraisals, auctioneering, accounting for surplus monies and complying with police regulations (R. 27). If only that part of its income truly representing payment

for the use of money were considered this taxpayer *even if a confessed holding company* could not be subject to this surtax because its income would not be 80% from interest.

As this meaning of the word "interest"—a payment made solely for the use of money—is at least as legitimate as any other that can be imagined, by what right does the Respondent reject it and adopt one less satisfactory? And what becomes of the rule that, where the language of a tax statute is open to reasonable doubt, the taxpayer is entitled to the benefit of it?

## Point II.

### **As to the Petitioner's Liability for Penalties.**

It should be kept clearly in mind that the penalty provisions of the statute (Revenue Act of 1934, Sec. 291) are not mandatory. It adds to the requirement that 25% be added to the amount of the tax for failure to file a return within the time specified the proviso, "except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax".

The tax is thus truly mandatory only where the taxpayer never attempts to comply with the requirement. That is not true in this case. In addition to the ordinary income and excess profits return the Petitioner filed two information returns, and his books and records were at all times open to the Commissioner. There is no pretense of concealment, or attempt at concealment.

Petitioner's books and records, which gave some indication that more than 50 percent. of its stock was owned by less than five stockholders and disclosed

that at least 80% of its income was derived from interest were at all times available to respondent and were actually made to respondent's agents during audit of the income tax returns for the taxable years." (R. pp. 27, 28).

There is thus no trace of bad faith or concealment in the case; and we are at a loss to see why the Petitioner has been so harshly dealt with. The Respondent has always had power to prepare a return for a taxpayer (Revised Statutes, Sec. 3176, as amended). Why did he not use it in this case? It is, of course, an ancient saw that ignorance of the law excuses no one; but no principal of law or equity, we venture to say, requires that the rule be given an extreme application in order to impose a penalty. The attitude of the courts has always been exactly the reverse. They impose penalties only in a plain case, and then with reluctance.

If the facts in the case at bar were the same as in *O'Sullivan Rubber Co. v. Commissioner*, 120 Fed. (2d) 845, 849—and we cannot deny a certain degree of similarity—the decision there would impede our argument, but with the very high degree of good faith and the accumulation of disclosures of all essential facts in the case at bar, we urge the applicability of the viewpoint so clearly and concisely expressed in the dissenting opinion in that case. Judge Hand said, among other things:

"In the absence of fraud no penalty is imposed upon an innocent taxpayer, however he may throw the Commissioner off the track; it falls only upon those who by failing to make any return at all have given him no lead which he can follow up. Given a lead and good faith it rests upon him to check the return. For this reason it seems to me that our decision is a triumph of letter over substance." (120 Fed. (2d) p. 849.)

### Point III.

**Sec. 351 of the Revenue Act, as construed by the Commissioner, violates the Fifth Amendment to the Constitution of the United States.**

Though the power of Congress to lay taxes is not questioned, it is still true that,—“This court has recognized that a statute purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment.” (*Nichols v. Coolidge*, 274 U. S. 531, 542.)

It needs no argument to show that a statute like the one under consideration might well be a convenience to the tax gatherer. An arbitrary definition is given to a “personal holding company”, and a heavy surtax is imposed upon the entity described. No attempt is made to square the definition with reality. The entity in question may, or may not, come within the ordinary, obvious, and natural meaning of a “holding company”. It is taxed in any event.

Such action cannot be justified on the mere plea of convenience. When constitutional rights are involved, the convenience of the tax gatherer ceases to have any importance. The point has received explicit attention.

*Schlesinger v. Wisconsin*, 270 U. S. 230, 240;

*Hoeper v. Tax Commission*, 284 U. S. 206, 217;

*Heiner v. Donnan*, 285 U. S. 312, 328.

In *Heiner v. Donnan* the statute considered attempted to create an irrebuttable presumption that transfers made by a decedent within two years of death were made “in contemplation of death”, and consequently taxable. The Court said:

“To sustain the validity of this irrebuttable presumption it is argued, with apparent conviction, that

under the *prima facie* presumption originally in force there had been a loss of revenue, and decisions holding that particular gifts were not made in contemplation of death are cited. This is very near to saying that the individual, innocent of evasion, may be stripped of his constitutional rights in order to further a more thorough enforcement of the tax against the guilty—a new and startling doctrine, condemned by its mere statement.” (285 U. S. p. 328).

The rights involved were held to be “superior to this supposed necessity” and the attempted legislation so arbitrary as to violate due process.

While the situation in the case at bar of course differs on the precise facts from that in the *Donnan* case, the attack on constitutional rights appears to be just as serious. Unlike the provisions in Sec. 102 of the statute, there is no reference to an intention on the part of the corporation “of preventing the imposition of the surtax upon its shareholders.” Such a purpose may have been, as in the case at bar, entirely absent from the minds of those organizing any given corporation or managing its affairs.

Even more serious is the fact that the tax is imposed upon some *operating* corporations, and not upon others, although the conditions in the two cases may be practically identical. A heavy tax is imposed upon corporations provided that “at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.” On the other hand, if such stock is held by six, or more than six, individuals, the corporation escapes this surtax entirely. It would be hard to explain or sanction such an arbitrary distinction.

It is undoubtedly true that Congress has a broad power to classify objects for purposes of legislation; but it is

equally well settled that this power must be exercised fairly and reasonably.

*Royster Guano Co. v. Virginia*, 253 U. S. 412, 415:

("But the classification must be reasonable, not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike.")

*Gulf, etc., Ry. Co. v. Ellis*, 165 U. S. 150, 155.

*Louisville Gas Co. v. Coleman*, 277 U. S. 32, 37.

*Frost v. Corporation Commission*, 278 U. S. 515, 522.

The present statute pays no attention to these constitutional requirements.

Thus it may be a reasonable classification to separate out all true holding companies for special taxation or, perhaps, even to define *all* corporations, both holding and operating, as "holding companies," and tax them as such, but to arbitrarily select *some* operating corporations, label them "holding corporations," and impose crushing taxation upon them, as such (which the Respondent herein claims is the proper application of the statute in question) is the clearest possible example of arbitrariness, unreasonableness and discrimination, against which the Fifth Article of Amendment to the Federal Constitution protects us.

### Conclusion.

The petitioner has shown that the due process clause of the Fifth Amendment would be violated if Section 351 of the Revenue Acts of 1934 and 1936, respectively, were applied to classify it, an active operating corporation, as a holding company. The petitioner has shown that there is no equivalence to justify such a statute or such an application, for general pawnbroking and loan companies do not enjoy the privileges of personal holding companies

and our national Legislature never intended that they be taxed as such. The United States Circuit Court of Appeals for the Second Circuit failed to act upon the conflict between the attempted application of said Section 351 to this taxpayer and the well and firmly established rules of constitutional law referred to above; it failed to protect petitioner in its right to the benefit of those well established constitutional rules. Furthermore, taxpayer has shown that its ample and accurate disclosures made in good faith to respondent preclude penalty for failure to file a formal personal holding company return.

It is respectfully submitted that this case calls for the exercise by this honorable Court of its supervisory powers in order that the construction and application of the Federal tax law involved be definitely settled and the errors of the United States Circuit Court of Appeals for the Second Circuit be corrected and that to such end a Writ of Certiorari should be granted and the Court should review the determination of said Circuit Court of Appeals and reverse it.

September 2nd, 1942.

(Sgd.) GERALD DONOVAN,

*Counsel for Petitioner.*

Of Counsel:

JAMES T. HEENEHAN,

FRANCIS F. STEVENS.

## APPENDIX.

### Statutes Involved.

The Revenue Act of 1934 provides (48 Stat. 680, ch. 277, p. 729):

#### SURTAX ON PERSONAL HOLDING COMPANIES

##### SECTION 351. (a) Imposition of Tax.

There shall be levied, collected, and paid, for each taxable year, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

- (1) 30 per centum of the amount thereof not in excess of \$100,000; plus
- (2) 40 per centum of the amount thereof in excess of \$100,000.

##### (b) DEFINITIONS—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, and other than a life-insurance company or surety company) if—(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For the purpose of determining the ownership of stock in a personal holding company—(C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its

shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a deduction for the purpose of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) Dividends paid during the taxable year.

(3) The term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but minus the sum of:

(A) Federal income, war-profits, and excess-profits taxes paid or accrued, but not including the tax imposed by this section;

(B) Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o) for the purposes therein specified; and

(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(4) The terms used in this section shall have the same meaning as when used in Title I.

## FAILURE TO FILE RETURN

SECTION 291. In case of any failure to make and file a return required by this title, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, 25 per centum of the tax shall be added to the tax, except that when a return is filed after such time and it is shown that the failure to file it was due to reasonable cause and not due to willful neglect no such addition shall be made to the tax. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 per centum addition to the tax provided in section 3176 of the Revised Statutes, as amended.

The Revenue Act of 1936, so far as the questions at bar are concerned, is substantially similar.